Islamic Jurisprudence:

<u>Out of the Books and out of the Box</u>

Mahmoud A. El-Gamal
Rice University

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Economic Analysis of the Law

"Often the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character" (p.23)

" A ... meaning of justice, perhaps the most common, is – efficiency. An effort will be made ... to explain some of these prohibitions in economic terms, but most cannot be... Always, however, economics can provide value clarification by showing society what it must give up to achieve a non-economic ideal of justice" (p.27)

Richard A. Posner, *Economic Analysis of the Law*,
4th ed., Little, Brown and Co., Boston, 1992

A Rare Instance of the Economic nature of "Justice"

"It is thus apparent from the law that what is intended by the prohibition of *Ribā* is what it contains of excessive injustice (*ghubn fā<u>h</u>ish*). In this regard, justice in [exchange] transactions is achieved by approaching equality. Since the attainment of such equality in items of different kinds is difficult, their values are determined instead in monetary terms (*with the Dirham and the Dīnār*).

For things that are not measured by weight and volume, justice can be determined by means of proportionality. I mean, the ratio between the value of one item to its kind should be equal to the ratio of the value of the other item to its kind.

For example, if a person sells a horse in exchange for clothes, justice is attained by making the ratio of the price of the horse to other horses the same as the ratio of the price of the clothes [for which it is traded] to other clothes. Thus, if the value of the horse is fifty, the value of the clothes should be fifty. [If each piece of clothing's value is five], then the horse should be exchanged for 10 pieces of clothing.

As for [fungible] goods measured by volume or weight, they are relatively homogenous, and thus have similar benefits [utilities]. Since it is not necessary for a person owning one type of those goods to exchange it for the exact same type, justice in this case is achieved by equating volume or weight since the benefits [utilities] are very similar..."

Ibn Rushd, M. *Bidāyat Al-Mujtahid wa Nihāyat Al-Muqta<u>s</u>id* , Dar Al-Ma[c]rifah, Beirut, 1997 (vol.3, pp.183-184)

In Contrast:
The pseudo-economics of some contemporary jurists

[Arabic reference suppressed out of respect (1998, pp. 142-3)]. In an argument that there is no need to find an Islamic alternative to modern futures, and that if one was needed, salam would do, one of the main scholars of Islamic Finance wrote:

"As for futures contracts, there has not been any evidence that they have a legitimate purpose for which a *Sharʿī* means of accomplishment should be found. In fact, whatever takes place in futures markets is not meant to effect actual trading. Instead, the intention [there] is profitable speculation, which is more akin to gambling than to trade.

In this regard, we have mentioned that there are two types of traders in futures markets: The first are speculators who neither intend to sell or buy commodities, but merely wish to capitalize on the spread between sales and purchase prices. This is clearly an illegitimate objective of profiteering without true trade, and profits from non-guaranteed commodities, which is forbidden by a clear [Canonical] Text.

The second-type futures traders try to hedge what they already possess. Thus, they deal in futures to avoid possible losses, as we have described previously. However, such hedging is only needed for goods that they wish to monopolize for a long period. Indeed, if they sold the commodities a few days after acquiring them, they would not need to hedge. Rather, they only deal in futures when they wish to monopolize some commodities for a longer period to increase their profits.

[*A grossly-misunderstood quotation from a text on futures, stating that a farmer may need to hedge the risk of falling prices over a long holding period*]

Thus, it is clear that merchants only need futures to hold goods for a considerable period, which most often is done out of the illegitimate objective of monopoly..."

The Books and the Box

- Jurisprudence books are historical documentations of applications of the *Sharīʿa* to specific legal and economic conditions.
- The historical record is driven by the two time-dependent institutions of *Qaḏāʾ* (justice) and *Futyā* (consultation)
  - The stated justification for a ruling may not help us to understand the *maqṣid* (objective) and *ḥikmah* (reason) of the ruling
  - Only the *ʿillah* (instigating factor) must be stated
- In the absence of a sophisticated legal system, named-contract rules of a *maḏhhab* provided local followers of that school with "the legal fine print" for transactions known to be devoid of prohibited factors (e.g. *Ribā* or *Gharar*) at the time of the ruling (e.g. *Murābaḥah, ʿIjārah, Muḍārabah, Salam, etc.*)
  - A transaction satisfying that fine print need not be permissible today, and
  - A permissible transaction today need not satisfy that fine print

“Convention” (√ℵ∈⇔↓): Islamic Jurisprudence as a historical *follower*

Appeals to “convention” (√ℵ∈⇔↓) reference count:

- *Al-Mabsūṭ* (Al-Sarakhsī, *Ḥanafī*) 130 references
- *Badā'iᶜ Al-Ṣanā'iᶜ* (Al-Kāsānī, *Ḥanafī*) 95 references
- *Radd Al-Muḥtār* (ibn-ᶜĀbidīn, *Ḥanafī*) 237 references
- *Sharḥ Mukhtaṣar Khalīl* (Al-Kharshī, *Mālikī*) 1182 references
- *Al-Majmūᶜ* (Al-Nawawī + Al-Subkī, *Shāfiᶜī*) 60 references
- *Al-Mughnī* (ibn-Qudāma, *Ḥanbalī*) 102 references

Appeals Relate to all contracts, including:

- Deposit contracts: even if unrestricted, are restricted by √ℵ⊂
- Acceptable forms for partnership capital: determined by √ℵ⊂
- Acceptable conditions in contracts (esp. leases and credit sales):
- Typical phrases:

  “≥ℵ°÷⌈↓ ��Φ∈⇑ √ℵ∈⇔↓” and

  “ΕΛ±↓ℵπ⇔↓ ��Φ∈⇑ ℵ°ϑΦ⇔↓ √ℵ⊂”

"Form above function": The Books and the Box: Anachronistic Convention

Operating vs. financial leases:

- Jurists require lessors to maintain substantial ownership (cost of repair, etc., c.f. Usmani, Taqi, *Introduction to Islamic Finance*, 1998, pp. 165-9)
- Those rulings are based primarily on *Radd Al-Muhtār* of ibn-ᶜĀbidīn (Damascus: 1783-1836 C.E.). Recall the latter's 237 references to √ℵ⊂, including in leases!
- Differentiation between selling claims on the asset and claims on its receivables result in arcane modes of securitization

Historical vs. contemporary notions of guaranty, risk, etc.:

- "Return is justified by commensurate risk" is a tautology when applied to financial markets
- In modern legal frameworks, there are many more forms of entitlement, other than partial ownership (e.g. *milk al-manfaᶜah*), total ownership (e.g. *milk al-raqabah wa l-manfaᶜah*), easement rights (*h̲uqūq al-'irtifāq*), etc.
- It is better to present the jurists with a useful, and commonly used contract, instead of trying to re-package modern dealings in historical juristic terms

Contemporary examples of "Function above form" (out of the box)

- Joint liability companies accepted as Rein (*ᶜinān*) partnerships with mutual guaranty (in defiance of the H̲anafī prohibition; c.f. ibn-Al-Humām)
- Joint stock companies:
  - Have legal personality
  - Managers are paid profit shares (*'Ijāra bi-l-G̲h̲arar*, or two contracts in one) [*Muḏāraba*+*'Ijāra*]

- In 1948, *Al-Azhar Iftā' Committee* permitted sheep partnerships where one party provides labor in return for all the milk, but both parties share wool according to capital shares (two contracts in one?)

- Based on √ℵ⊂, c.f. Dr. ᶜAlī Al-K̲h̲afīf, ⌈⇑ζℜ⌈↓ τφη⇔↓ �∝°∧ℵ ς⇔↓)

Two main problems with "Form above function?"

- Consider contracts ***A*** and ***B***, one forbidden and the other permissible based on juristic analogy (⌈©φ∏ ℘° ϖ·).
- If contracts ***A*** and ***B*** are shown to be economically identical (in the Arrow-Debreu sense; ***A≡B***), do we:
  - Forbid ***B***, through the apparent analogy (τX⊗ ℘°ϖ ·)?
  - Permit ***B***, while forbidding ***A*** ➔ allows for the fallacy of composition; avoids iterative analogy = ℘°ϖ· /ν⊂ ℘°ϖ ·)?
  - Or, revoke the earlier false juristic analogy based on the economic analysis of its proof (οϖ⇔—) and reasoning (Eν ⊆)?

- **The fallacy of composition and *new* *<u>hiyal</u>*** (a.k.a. "Islamic Financial Engineering"):
  - If ***A≡B+C***, and the jurists forbid ***A***, see if they accept ***B*** and ***C*** (e.g. *<u>s</u>ukūk al-salam*, *Murābaha lil'āmir bishshriā'*)
  - If ***B*** is forbidden, but ***A*** is permissible, and ***A≡B+C***, try to get jurists to accept ***C*** (e.g. synthetic embedded options)
  - Search the historical books of jurisprudence for ***A***, ***B*** or ***C***
- In all cases, charge the customer a premium for the relatively inefficient "Islamic" (or "Islamized") alternative

Case Study: DJII screening rules

- **Asymmetric screening rules (hotels vs. companies with interest-bearing debt < 33%):**
  - Is 33% or more of a hotel's business illicit? Isn't *Ribā* more illicit than alcohol?
  - Induces sectoral bias (NASDAQ-bias of DJII)
- **Asymmetric treatment of existing vs. newly assumed debts:**
  - Invites the creation of SPEs, and other accounting tricks to hide interest-bearing debt
  - Gives an unfair advantage to non-Islamic-run firms
- **Hard financial ratio cutoff rules:**
  - An extra source of volatility for Islamic funds
  - Pro-cyclical:
    - good companies can acquire new debt and must be dropped
    - poor credit companies can't acquire new debt and may be kept
  - Sell low, buy high!
    - when price falls, market cap falls, debt ratio rises
- **Much better Islamic portfolio selection rules can be devised!**

Economic Analysis of Islamic Law

- When we study the economics of classical jurists (ibn Taymiyyah, ʿibn Rushd, ibn Al-Qyyim, Al-Ghazali,...), we should not look to import their thought into our current times
- Instead, we should look to replace their outdated economic thought with our state of the art knowledge, and replace their historical setting with our current legal technology
- We would thus utilize their methods of understanding the *Sharīʿa* in light of the best knowledge of their times
- Otherwise: **To imitate an original**

  ... is to miss the point!

- To advertise my work and invite you to this research program:
  - "An Economic Explication of the Prohibition of *Ribā* in Classical Islamic Jurisprudence": (Forbidden *Ribā* is the unbundled trading in credit)

http://www.ruf.rice.edu/~elgamal/files/riba.pdf

  - "An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence": (Forbidden excessive *Gharar* is the unbundled trading in risk)

http://www.ruf.rice.edu/~elgamal/files/gharar.pdf